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Celia Nogales
Director - Federal Relations

July 31, 1996

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC   20554

> Re: **Ex Parte Statement**
> Docket 96-45

Dear Mr. Caton:

On July 31, 1996, Dr. Barbara Cherry, Mr. Phil Romo, Mr. Harry Albright and I met with Ms. Pam Szymczak, Mr. David Krech, Mr. Gary Seigel, Mr. Ted Burmeister, Mr. Bob Loube and Mr. Alex Belinfante of the Common Carrier Bureau, Mr. Luis Enriquez of the Office of Plans and Policy, and Mr. Mark Long, Florida PSC (by telephone) to discuss competitive bidding and DEM weighting issues as they relate to Ameritech's position in the above referenced proceeding. The attached material was used as part of the discussion.

Sincerely,

Celia Nogales

Attachment
cc: P. Szymczak
      D. Krech
      G. Seigel
      T. Burmeister
      A. Belinfante
      L. Enriquez
      M. Long
      B. Loube

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AMERITECH'S EX PARTE MATERIALS
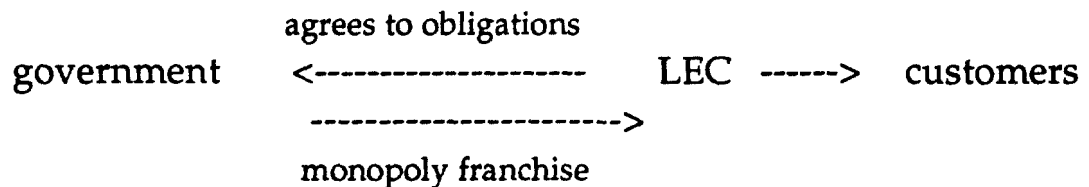# REGARDING COMPETITIVE BIDDING PROCESSES

July 31, 1996

STRUCTURING A COMPETITIVE
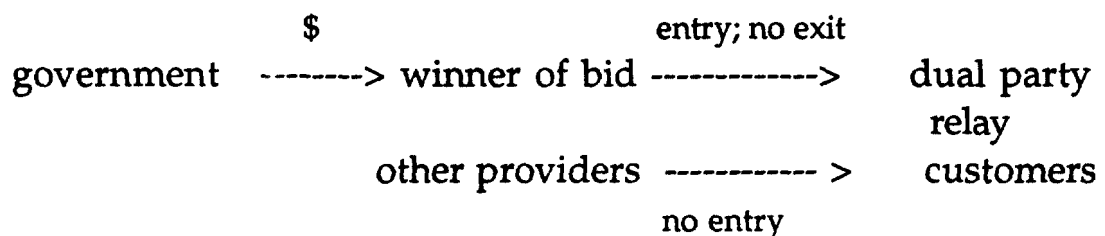# BIDDING PROCESS FOR
LOCAL EXCHANGE SERVICE

- Competitive bidding mechanisms have been proposed by various parties for purposes of determining carriers of last resort (COLR). This presentation reviews requirements for a sustainable competitive bidding process and, therefore, the appropriateness of various parties' proposals.

- Carrier of last resort obligations need to be carefully defined. Traditionally, it has meant the obligation of a provider to serve all customers upon reasonable request within a given geographic area and with a barrier to exit.

- In this regard, it is important to note that, when the given geographic area is a high cost area, the fulfillment of carrier of last resort obligations and the provision of service to high cost areas are inextricably intertwined.

- By this definition, a carrier of last resort (COLR) is likely to be required to serve some customers at prices set below costs, particularly in high cost areas. This is because, if all customers could be served at cost or at a profit, there would be no need for government to impose such an obligation on a provider in order for such customers to receive service.

- Thus, a carrier of last resort is likely to require revenues from sources other than those customers for which it must serve below cost.

TRADITIONAL USE OF BILATERAL COMMITMENTS

- Traditionally, local exchange carriers of last resort could recover sufficient revenues in totality, across all services and customers, through grant of a monopoly franchise by government to incumbent local exchange providers (LEC's). According to the typology developed by Dr. Barbara Cherry and Prof. Steven Wildman, this arrangement between government and the LEC's is a form of bilateral commitment.

```
                         agrees to obligations
     government      <-------------------     LEC ------>   customers
                     ---------------------->
                         monopoly franchise
```

- A similar type of bilateral commitment - where an obligation to provide service with an exit barrier is placed on a provider in exchange for which government blocks entry by other providers - continues to be used today for the provision of dual party relay service (DPR).

```
                    $                        entry; no exit
   government   --------> winner of bid ------------->     dual party
                                                          relay
                        other providers ----------- >     customers
                                          no entry
```

- The similarity is that both COLR's and providers of DPR have been awarded monopolies in order to fulfill their respective obligations.

- However, the difference is that only the provider of DPR has been selected through a competitive bidding process.

IS COMPETITIVE BIDDING FOR COLR'S
SUSTAINABLE WITH LOCAL EXCHANGE COMPETITION?

- The critical question is how can carrier of last resort obligations be fulfilled by providers while embracing the pro-competition policy of the Telecommunications Act of 1996.

- A competitively neutral explicit funding mechanism is the means of recovering additional revenue, where needed to cover carrier of last resort obligations, that is most compatible with competition.

- But how should the selection of COLR's and the amount of funding be determined for such an explicit funding mechanism?

- Various parties have proposed a competitive bidding or auction mechanism.

- For purposes of the discussion here, the critical question then becomes: How can a bidding process for carrier(s) of last resort for local exchange service be structured so as to be sustainable and to permit provision of local exchange service by more than one provider?

DIFFERENCES BETWEEN PCS AND COLR
COMPETITIVE BIDDING PROCESSES

- One can not automatically assume that the bidding process used for licensing of PCS spectrum will be appropriate for COLR's.

- There is a fundamental difference between a carrier's use of PCS spectrum and a carrier's provision of service as a COLR.

  <u>A PCS provider does not have a barrier to exit, whereas a COLR provider does.</u> A PCS provider may discontinue service and either forfeit the license or sell it to another provider upon FCC approval. A COLR may not discontinue service.

  This barrier to exit is a fundamental characteristic of a COLR.

- This distinction between PCS and COLR providers is critical, as the barrier to exit is what poses the sustainability problems for COLR's competing with non-COLR, local exchange competitors.

BIDDING PROCESS WITH COMPETITION?

- Important parameters of the bidding process must be defined in advance in order to determine the advantages and disadvantages associated with a given bidding process. These parameters include:
    - the triggering event for placing an area up for bid.
    - the duration of the bid (or contract) for which the winning bidder(s) bears carrier of last resort obligations.
    - whether the bidding process is to select one COLR or to allow for multiple COLR's.
    - whether entry is permitted by non-COLR's during the contract term of the bid.
    - whether the type or definition of services that the winning bidder is to provide can be expanded or modified prior to when the carrier of last resort obligations are rebid.
    - the process by which the winning bid will be determined.

- The parameters of a bidding process, such as those listed above, will affect the performance of the process. However, the following scenarios demonstrate that, in order for competitive bidding mechanisms to be sustainable, the following conditions must hold :

    (1) Universal service support for carrier of last resort obligations and high cost areas must be portable only to other COLR's serving the relevant area.
    (2) The same obligations must be placed on all COLR's, or, if the obligations differ, then the COLR's bearing the greater obligations must be compensated for the increased risk and financial burden arising from such obligations.
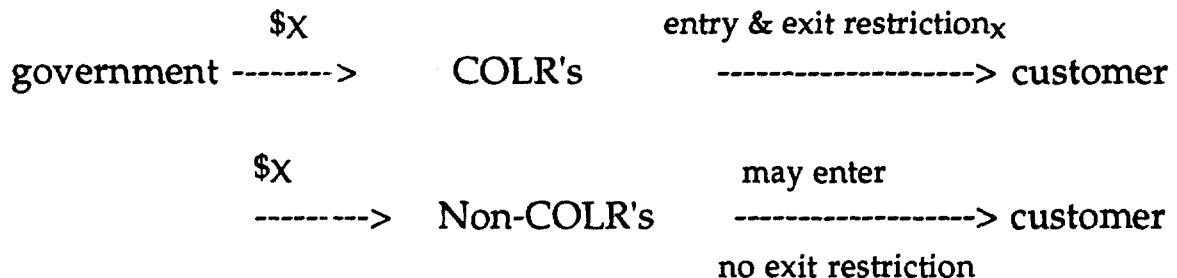
BIDDING PROCESSES
UNSUSTAINABLE WITH COMPETITION:
PORTABILITY OF FUNDS TO NON-COLR'S

- <u>Asymmetry in Obligations with Portability of Funds to Non-COLR's</u>

    Assumptions:
    (1) Number of COLR's to be selected is ≥ 1.
    (2) Entry by non-COLR's is permitted during the contract term.
    (3) Non-COLR's are eligible for same funding as the COLR's.
         (This is the IXC's "portability of subsidies" argument.)

    The following scenario is created:

    ```
                  $x                        entry & exit restriction_x
    government -------->   COLR's         --------------------> customer


                  $x                            may enter
              ---------->   Non-COLR's   -------------------> customer
                                          no exit restriction
    ```

    where the financial burden of (exit restriction$_x$ - no exit restriction) > 0.

- The ability of the COLR's to continue providing universal service in the designated area is threatened because its non-COLR competitors are receiving the same compensation but with fewer obligations and therefore a lower financial burden.

- Conclusion: Sustainability requires portability of support, both for COLR and high cost areas, only to other COLR's serving the relevant area.
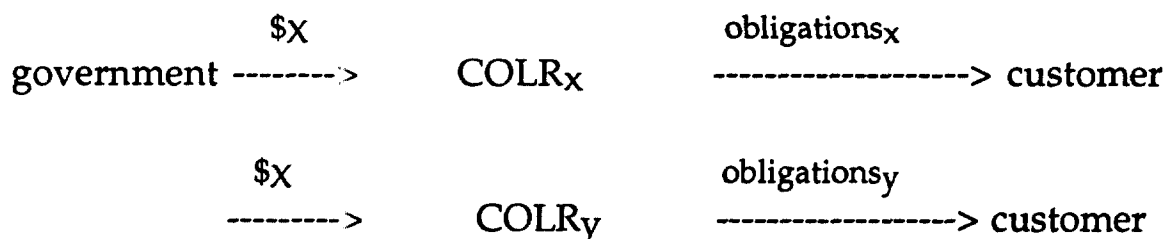
PORTABILITY OF FUNDS TO NON-COLR'S:
VARIOUS PARTIES' PROPOSALS

- GTE's proposal correctly identifies the portability of funds problem between COLR's and non-COLR's, and advocates that only COLR's should be eligible for support.

- IXC's proposals for requiring high cost funds to be portable between providers do not address or recognize the unsustainability problem posed by allowing non-COLR's to also receive the same funds as COLR's. This is because the IXC's wish to serve only portions of high cost areas, selected at will by them, and are not willing to serve entire high cost areas nor to commit to a barrier to exit for that area (i.e. the carrier of last resort obligations). Yet such obligations are inextricably a part of serving high cost areas. In essence, IXC's are advocating portability of funds to non-COLR's and the associated sustainability problems.

BIDDING PROCESSES
<u>UNSUSTAINABLE</u> WITH COMPETITION:
ASYMMETRY IN OBLIGATIONS BETWEEN COLR'S
AND THE SAME COMPENSATION TO ALL COLR'S

- <u>Asymmetry in Obligations Between COLR's and the Same Compensation to all COLR's</u>

- Assumptions:
    (1) Number of COLR's >1.
    (2) There is asymmetry in obligations between COLR's.
    (3) All COLR's receive the same amount of funding.

The following scenario is created:

$$\begin{array}{lll}
& \$_X & \text{obligations}_X \\
\text{government} \text{-------->} & \text{COLR}_X & \text{-------------------->} \text{customer}
\end{array}$$

$$\begin{array}{lll}
& \$_X & \text{obligations}_y \\
\text{--------->} & \text{COLR}_y & \text{----------------->} \text{customer}
\end{array}$$

where obligations_X > obligations_y, and the financial burdens of the respective obligations is such that $(\text{obligations}_X - \text{obligations}_y) > 0$.

- The ability of COLR's obligations_X to continue providing universal service in the designated area is threatened because the COLR's bearing obligations_y are receiving the same compensation but with lesser obligations and therefore a lower financial burden. Furthermore, constitutional problems may be created by imposing greater obligations on some COLR's without just compensation for their increased financial burden on such COLR's.

BIDDING PROCESSES
<u>SUSTAINABLE</u> WITH COMPETITION:
REMOVE OR COMPENSATE FOR ASYMMETRIES
IN OBLIGATIONS BETWEEN COLR'S

- Analysis of the preceding scenario shows that there are two basic options for restoring sustainability when there is asymmetry in obligations between COLR's yet the same amount of compensation is paid to all COLR's. For purposes of presentation here, they will be referred to as Options 1 and 2.

- Option 1: Eliminate the asymmetry.
  - Require $obligations_x = obligations_y$; or

- Option 2: Compensate the COLR's with greater obligations for the associated difference in risk and financial burden.
  - Compensation to $COLR_x$ should be greater than the compensation to $COLR_y$ in the amount of ($obligations_x$ - $obligations_y$).

- **Conclusion: Sustainability requires that the same obligations be placed on all COLR's, or, if the obligations differ, that the COLR's bearing the greater obligations be compensated for the increased risk and financial burden arising from such obligations.**

BIDDING PROCESSES
<u>SUSTAINABLE</u> WITH COMPETITION:
REMOVAL V. COMPENSATION FOR ASYMMETRIES
IN OBLIGATIONS AMONG COLR'S

- Implementation of Option 1: Removal of Asymmetries in Obligations Among COLR's
  - In order to eliminate asymmetries in obligations, it is critical to identify the relevant obligations that must be the same for all COLR's.
  - For example, it is obvious that sustainability requires all COLR's to bear the same exit restrictions. However, due to their effects in the marketplace when coupled with traditional COLR obligations, asymmetries in other types of obligations may pose sustainability problems as well. One example is the asymmetry in resale requirements that would occur if incumbent LEC's, as COLR's, must unbundle and resale network components, but new local exchange carriers, as COLR's, must only resale entire services. <u>All relevant obligations for sustainability purposes must be identified and addressed.</u>

- Implementation of Option 2: Greater Compensation to COLR's Bearing Greater Obligations
  - All the requisite obligations for sustainability purposes must be identified, as described under option (1).
  - The amount (obligations$_x$ - obligations$_y$) must also be calculated. This value will likely be difficult to calculate by either the parties or the regulator, and the value is likely to vary as the parameters of a bidding process, such as those listed earlier, change. For this reason, option 1 may be preferable to 2.

- **Conclusion: Due to implementation difficulties, it may be preferable to require symmetry in obligations among all COLR's, rather than to permit asymmetry in obligations among COLR's and to compensate the COLR's bearing the greater obligations for the increased risk and financial burden arising from such obligations.**

REMOVE OR COMPENSATE FOR ASYMMETRIES
IN OBLIGATIONS AMONG COLR'S:
VARIOUS PARTIES' PROPOSALS

- GTE's proposal correctly recognizes that a requirement of the bidding process is that a provider's eligibility for support requires assumption of all the obligations for which the support was intended. GTE also correctly notes that all the obligations of a COLR must be carefully identified and defined. Thus, GTE's proposal, that all recipients of support must bear the same carrier of last resort obligations, is similar to option 1. However, the GTE proposal does not address the possibilty of using a process as described under option 2.

- The "portability of funds" argument of the IXC's does not address or acknowledge the need for selecting option 1 or option 2 to achieve sustainability.

BIDDING PROCESSES
<u>SUSTAINABLE</u> WITH COMPETITION:
NO ENTRY BY NON-COLR'S

- Competitive bidding processes can also differ as to whether or not they permit entry by non-COLR's during the contract term of the bid. Two different approaches will be discussed here.

- <u>No Entry Permitted by Non-COLR's</u>

  Assumptions:
  (1) Number of COLR's to be selected is ≥ 1.
  (2) No entry by non-COLR's, i.e. all new entrants must be COLR's.
  (3) All COLR's have the same obligations and eligible for the same compensation.

  Results:
  - Bids by COLR's do not need to reflect the increased risk of revenue shortfalls due to loss of customers to niche entrants.
  - Niche local exchange providers do not exist.

- This approach is sustainable with local exchange competition, but permits competition only among providers accepting full symmetric obligations but not between COLR's and niche providers.

- The amount of compensation to be paid to COLR's under this approach will be <u>less</u> than that needed to be paid to COLR's when entry by non-COLR's is permitted, thereby decreasing the size of the explicit fund.

BIDDING PROCESSES
SUSTAINABLE WITH COMPETITION:
ENTRY BY NON-COLR'S

- ## Entry Permitted by Non-COLR's

    Assumptions:
    - (1) Number of COLR's to be selected is ≥ 1.
    - (2) Entry by non-COLR's is permitted.
    - (3) Non-COLR's are not eligible for compensation (due to unsustainabilty of portability of funds to non-COLR's).

    Results:
    - Bids by COLR's will reflect the increased risk of revenue shortfalls due to loss of customers to niche entrants.
    - Niche local exchange providers do exist.

- This approach is sustainable with local exchange competition, permitting competition between COLR's and niche players.

- However, the amount of compensation to be paid to COLR's under this approach will be greater than that needed to be paid to COLR's when entry by non-COLR's is not permitted, thereby increasing the size of the explicit fund.

- Conclusion: A priori, there is no clear preference between competitive bidding processes which do or do not permit entry by non-COLR's during the contract term of a bid. Selection of one approach over the other involves a trade-off between different policy objectives - allowing more competition by niche players v. size of the explicit fund for COLR obligations and high cost support.

ENTRY V. NO ENTRY BY NON-COLR'S:
VARIOUS PARTIES' PROPOSALS

- Dennis Weller, Chief Economist of GTE, in a paper recently presented at the Rutgers University Ninth Annual Western Conference, recognized different approaches of permitting or not permitting entry of non-COLR's during the contract term of a bid. In this paper, he chose to select the approach which would permit entry by non-COLR's.

- At this time, it appears that further analysis should be conducted and the policy tradeoffs (between niche entry and the size of the fund) more thoroughly examined before a preference for an approach favoring "entry" or "no entry" by non-COLR's is selected.

SUMMARY

- If a bidding process for selecting COLR's for local exchange service and for quantifying COLR support is to be utilized, it must be structured so as to be sustainable and to permit provision of local exchange service by more than one provider.

- Sustainability of a competitive bidding mechanism requires that the same obligations be placed on all COLR's, or, if the obligations differ, that the COLR's bearing the greater obligations be compensated for the increased risk and financial burden arising from such obligations.

- Due to difficulties of implementation, it may be preferable to require symmetry in obligations among all COLR's, rather than to permit asymmetry in obligations among COLR's and to compensate the COLR's bearing the greater obligations for the increased risk and financial burden arising from such obligations.

- Theoretically, there is no clear preference between competitive bidding processes which do or do not permit entry by non-COLR's during the contract term of a bid. Selection of one approach over the other involves a trade-off between different policy objectives - allowing more competition by niche players v. size of the explicit fund for COLR obligations and high cost support - and may be affected by other parameters of the bidding process.

CC Docket 96-45 - Universal Service

# DEM Weighting Post TA96

July 31, 1996

DEM Weighting - Ameritech Position

- The DEM Weighting program should be eliminated immediately

- If the FCC decides to continue assistance for local switching, such assistance should be removed from rates and recovered in a competitively neutral manner

Some DEM Weighting Receipients
Have Extremely High Local Switching Rates

Legend:
- Moultrie Independent
- Home Telephone Company
- NECA
- Ameritech
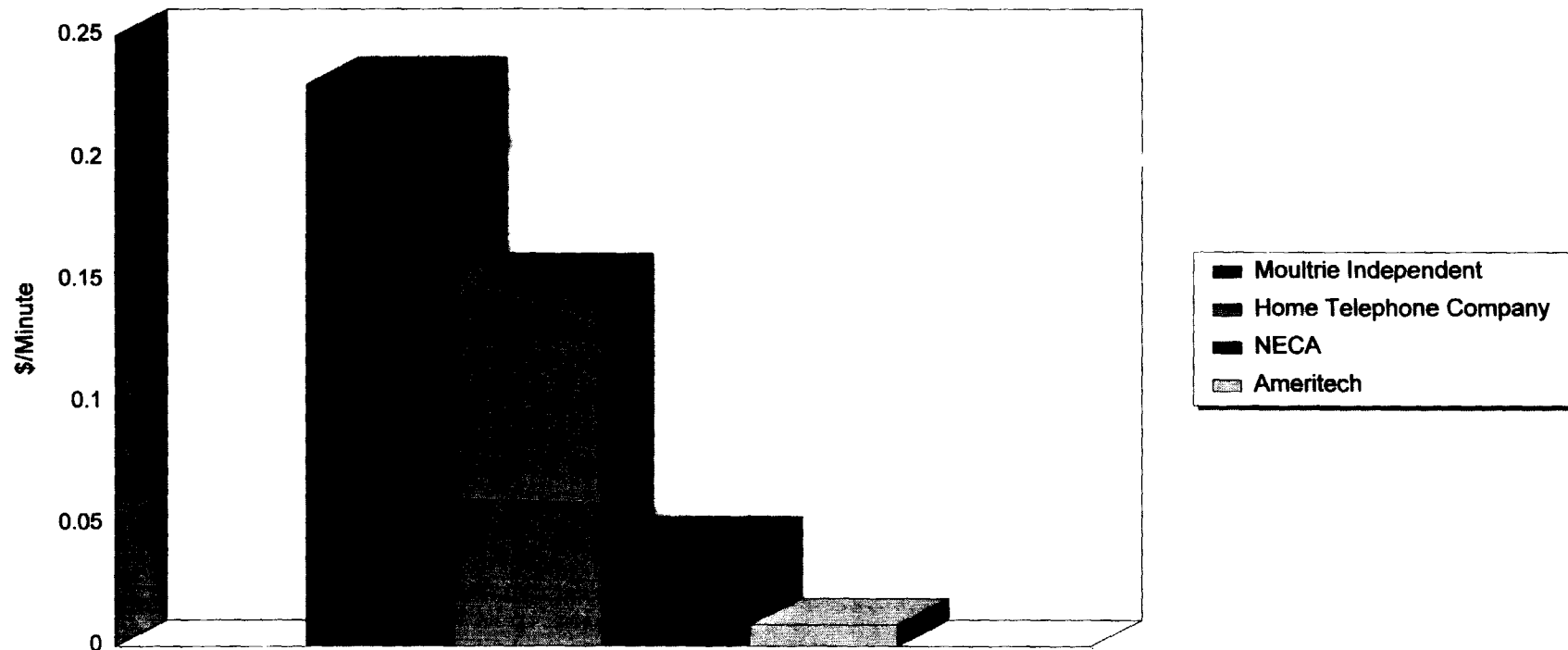
	Local Switching Rate	DEM Weight	
Moultrie Independent	$0.23013	3.0	
Home Telephone Company	$0.15015	3.0	
NECA	$0.04220	2.0	(Approximate)
Ameritech	$0.00874	1.0	

DEM Weighting Should be Eliminated Immediately

- As an implicit subsidy, it is incompatible with a competitive market and with the Communications Act of 1996

- It is not related to high cost

- It irrationally assigns more subsidy where there is no increase in cost

- It allows LECs to recover more than 100% of their Local Switching costs

- It allows LECs to keep local rates artificially low

- It does not promote efficiency

- It improperly subsidizes investments for technology that goes beyond "Basic Local Service"

- Elimination of DEM Weighting would not cause a hardship for the vast majority of customers

Background on DEM Weighting

- Originally, DEM Weighting was designed as a way to recognize the additional cost of switching toll minutes in electromechanical switches (February, 1971 Separations Manual).

- The Current DEM Weighting mechanism was adopted during the Separations Manual rewrite replacing Part 67 with Part 36.

- Because the rewrite of the Separations Rules eliminated the Traffic Sentitive (TS)/Non-Traffic Sensitive (NTS) distinction and made other simplifications, DEM weighting was developed to provide assistance to small carriers who may have been adversely affected by the elimination of the TS/NTS distinction.

- At the time Part 36 was adopted, the FCC recognized that the need for DEM weighting would diminish over time (and eventually be eliminated) as digital switching technology was deployed.

- DEM Weighting allows companies to assign more of their local switching investment to the interstate jurisdiction by multiplying the DEM factor by the following:

Number of Access Lines in Study Area	Weighting Factor
0 - 10,000	3.0
10,001 - 20,000	2.5
20,001 - 50,000	2.0
50,001 - or above	1.0

DEM Weighting combined with mirrored access rates can lead to a windfall: An Example

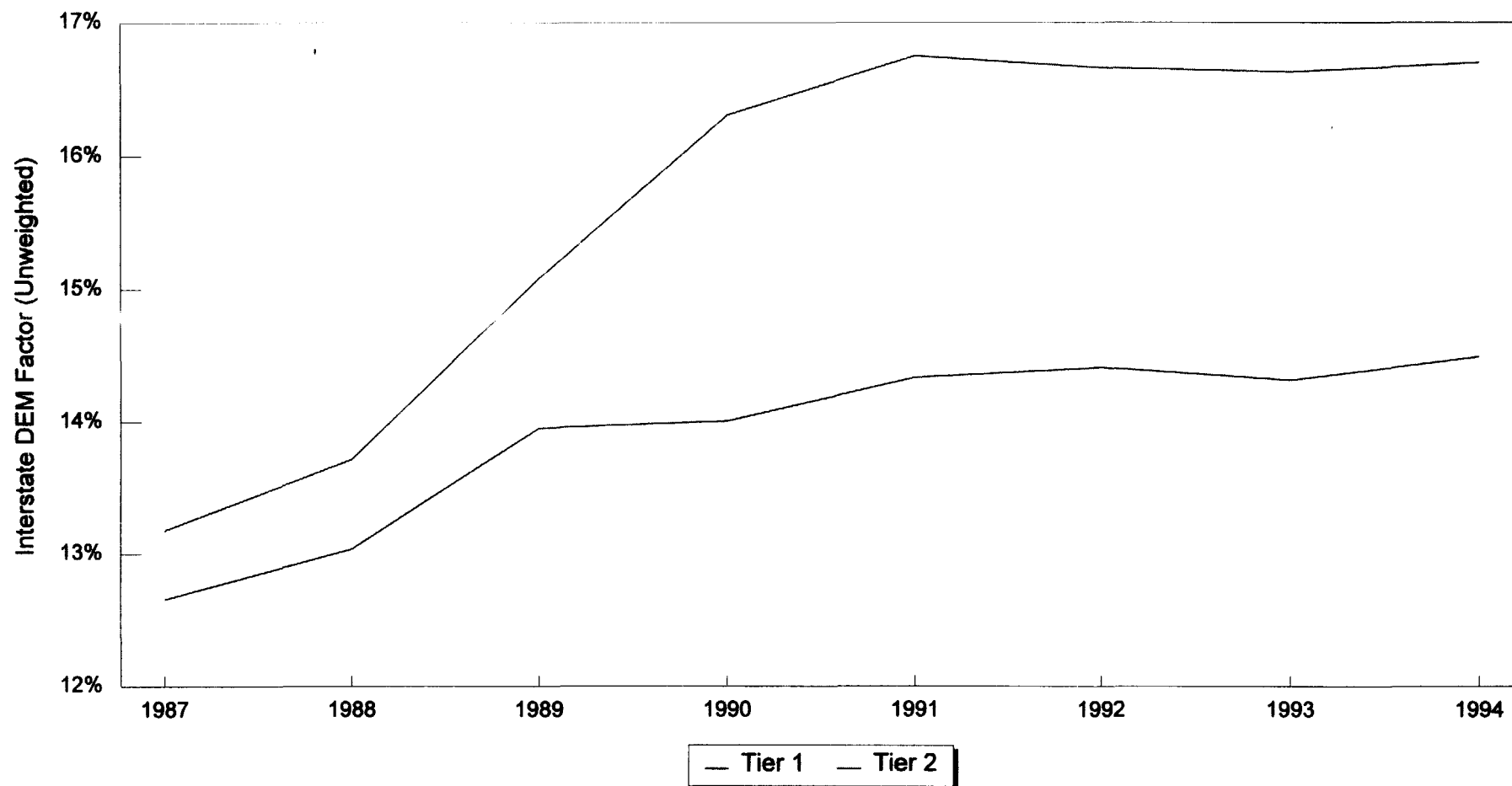|		(a) Total	(b) Interstate	(c) State Access	(d) State Toll & Local
1 Unweighted DEM Factor			20.0%	20.0%	60.0%
2 DEM Weighting			3.0		
3 Weighted DEM Factor	Ln 2 x Ln 1		60.0%	20.0%	60.0%
4 Unweighted Local Switching Investment	Ln 1 x Ln 4(a)	$10,000,000	$2,000,000	$2,000,000	$6,000,000
5 Weighted Local Switching Investment	Ln 3 x Ln 5(a)	$10,000,000	$6,000,000	$2,000,000	$2,000,000 *
6 Revenue Requirement Factor		30%			
7 Unweighted Local Switching Revenue Requirement	Ln 6 x Ln 4	$3,000,000	$600,000	$600,000	$1,800,000
8 Weighted Local Switching Revenue Requirement	Ln 6 x Ln 5	$3,000,000	$1,800,000	$600,000	$600,000 *
9 Minutes of Use		30,000,000	6,000,000	6,000,000	18,000,000
10 Unweighted Cost per Minute	Ln 7/Ln9	$0.10	$0.10	$0.10	$0.10
11 Weighted Cost per Minute	Ln 8/Ln9	$0.10	$0.30	$0.10	$0.03 *
12 Mirrored Rates			$0.30	$0.30	$0.03
13 Costs Recovered Using Mirrored Rates	Ln 12 x Ln 9	$4,200,000	$1,800,000	$1,800,000	$600,000
14 Total Over Recovery of Costs	Ln 13-Ln 7	$1,200,000			
15 Costs Recovered from Access Only	Ln 13 (b) + (c)	$3,600,000			
16 Over Recovery of Costs from Access Only	Ln 15-Ln 7	$600,000			

* Note: State Toll & Local is computed as Total - Interstate - State Access in order to avoid overrecovering costs

Furthermore, an increase in interstate DEM can increase the windfall

		(a) Total	(b) Interstate	(c) State Access	(d) State Toll & Local
1 Unweighted DEM Factor			21.0%	21.0%	58.0%
2 DEM Weighting			3.0		
3 Weighted DEM Factor	Ln 2 x Ln 1		63.0%	21.0%	58.0%
4 Unweighted Local Switching Investment	Ln 1 x Ln 4(a)	$10,000,000	$2,100,000	$2,100,000	$5,800,000
5 Weighted Local Switching Investment	Ln 3 x Ln 5(a)	$10,000,000	$6,300,000	$2,100,000	$1,600,000 *
6 Revenue Requirement Factor		30%			
7 Unweighted Local Switching Revenue Requirement	Ln 6 x Ln 4	$3,000,000	$630,000	$630,000	$1,740,000
8 Weighted Local Switching Revenue Requirement	Ln 6 x Ln 5	$3,000,000	$1,890,000	$630,000	$480,000 *
9 Minutes of Use		30,000,000	6,300,000	6,300,000	17,400,000
10 Unweighted Cost per Minute	Ln 7/Ln9	$0.10	$0.10	$0.10	$0.10
11 Weighted Cost per Minute	Ln 8/Ln9	$0.10	$0.30	$0.10	$0.03 *
12 Mirrored Rates			$0.30	$0.30	$0.03
13 Costs Recovered Using Mirrored Rates	Ln 12 x Ln 9	$4,260,000	$1,890,000	$1,890,000	$480,000
14 Total Over Recovery of Costs	Ln 13-Ln 7	$1,260,000			
15 Costs Recovered from Access Only	Ln 13 (b) + (c)	$3,780,000			
16 Over Recovery of Costs from Access Only	Ln 15-Ln 7	$780,000			

* Note: State Toll & Local is computed as Total - Interstate - State Access in order to avoid overrecovering costs

The Unweighted Interstate DEM Factor has grown faster for DEM Weighting Recepients

	1987	1988	1989	1990	1991	1992	1993	1994
Tier 1	12.7%	13.0%	14.0%	14.0%	14.3%	14.4%	14.3%	14.5%
Tier 2	13.2%	13.7%	15.1%	16.3%	16.7%	16.7%	16.6%	16.7%

Source: Monitoring Report, CC Docket No. 87-339, May, 1996,Tables 4.17 & 4.18
     1987 & 1988 July, 1992 Monitoring Report, Tables 4.11 & 4.12